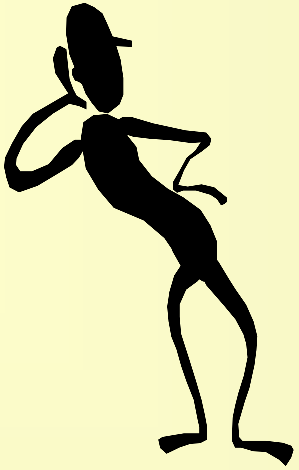
Chapter 10

Monopolistic Competition and Oligopoly

These slides supplement the textbook, but should not replace reading the textbook

What is imperfect competition?

A market structure between pure competition and monopoly



What is monopolistic competition?

A market structure in which a large number of firms sell close substitutes which are different enough that each firm’s demand curve slopes downward

How can firms differentiate under monopolistic competition?

- Physical differences
- Location
- Services
- Product image

What are examples of monopolistic competition?

- Restaurants
- Clothing stores
- Grocery stores
- Jewelry stores

Where are profits maximized or minimized ?

$$MR = MC$$

The Firm Monopolistic Competition in the Short Run

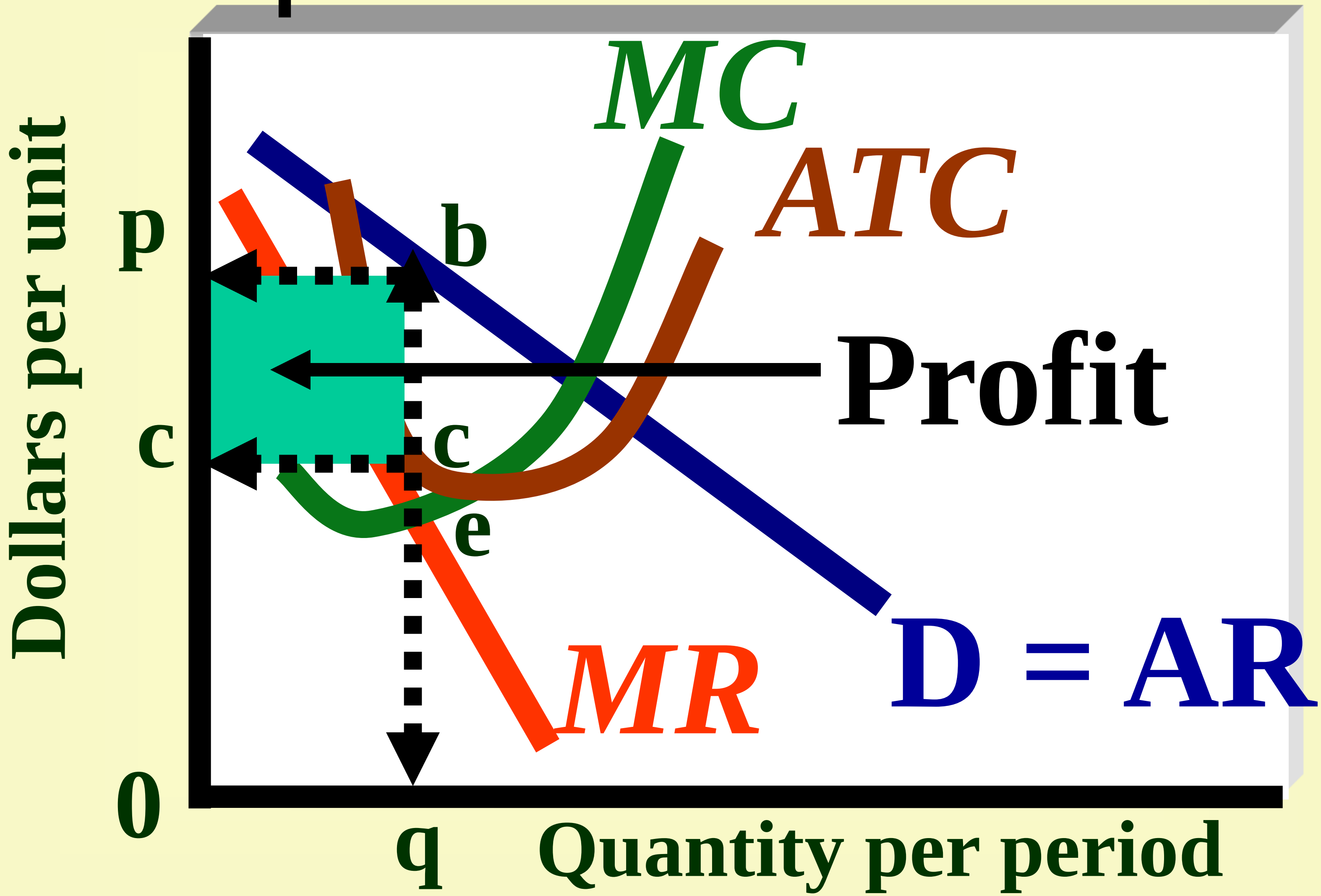


Exhibit 1 (a)

The Firm Monopolistic Competition in the Short Run

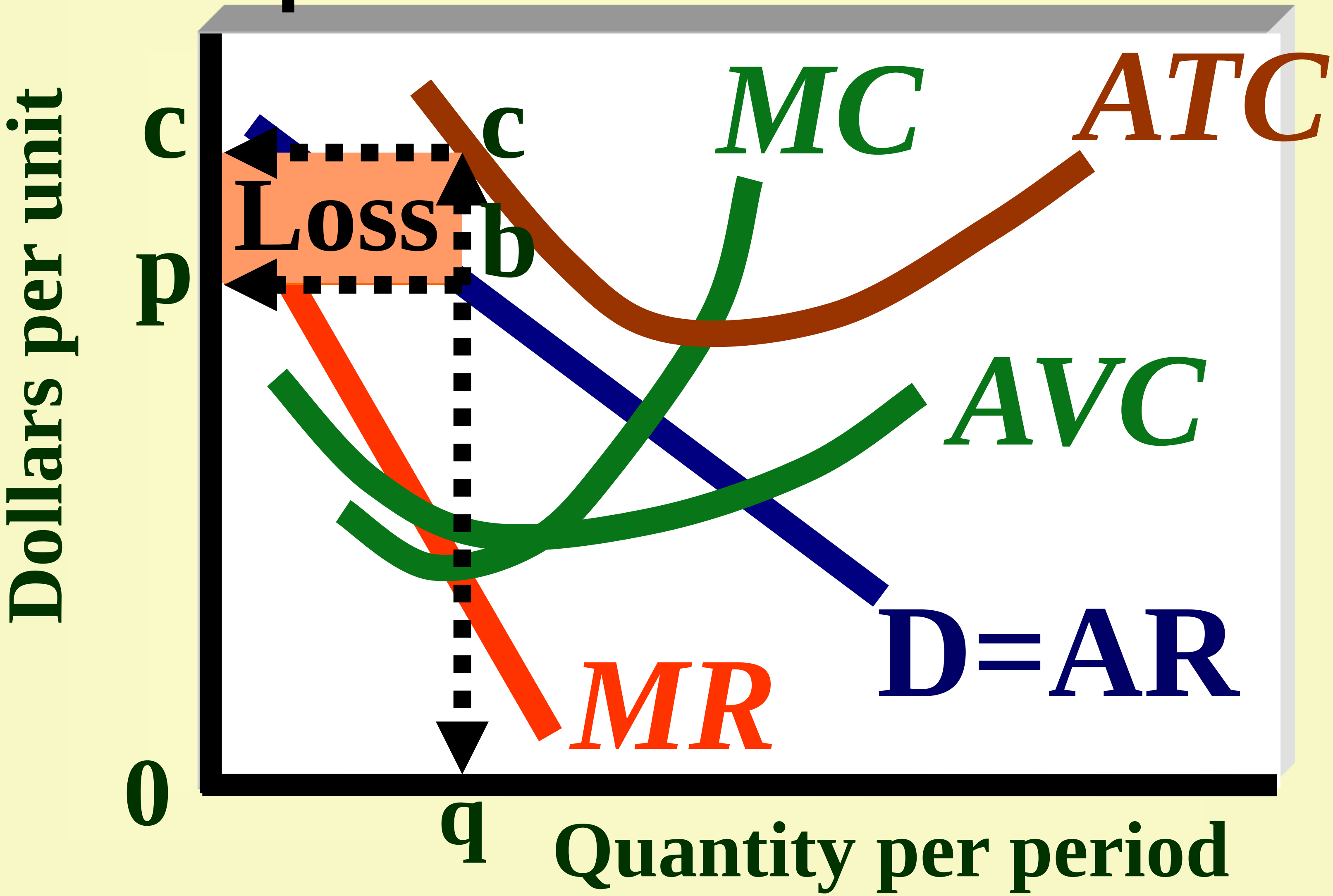
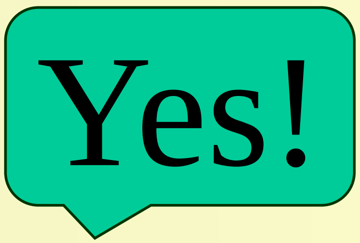


Exhibit 1 (b)

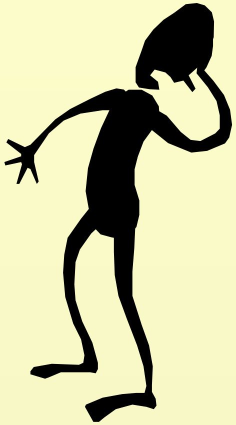
In monopolistic competition, can economic profit be made in the short run?



Positive or negative economic profit can be made in the short run

What is long-run profit in monopolistic competition?

Zero



Why is economic profit zero over the long-run?

Because if economic profits are being made more firms will enter into the industry; if losses are being made more firms will leave the industry

Long Run Equilibrium in Monopolistic Competition

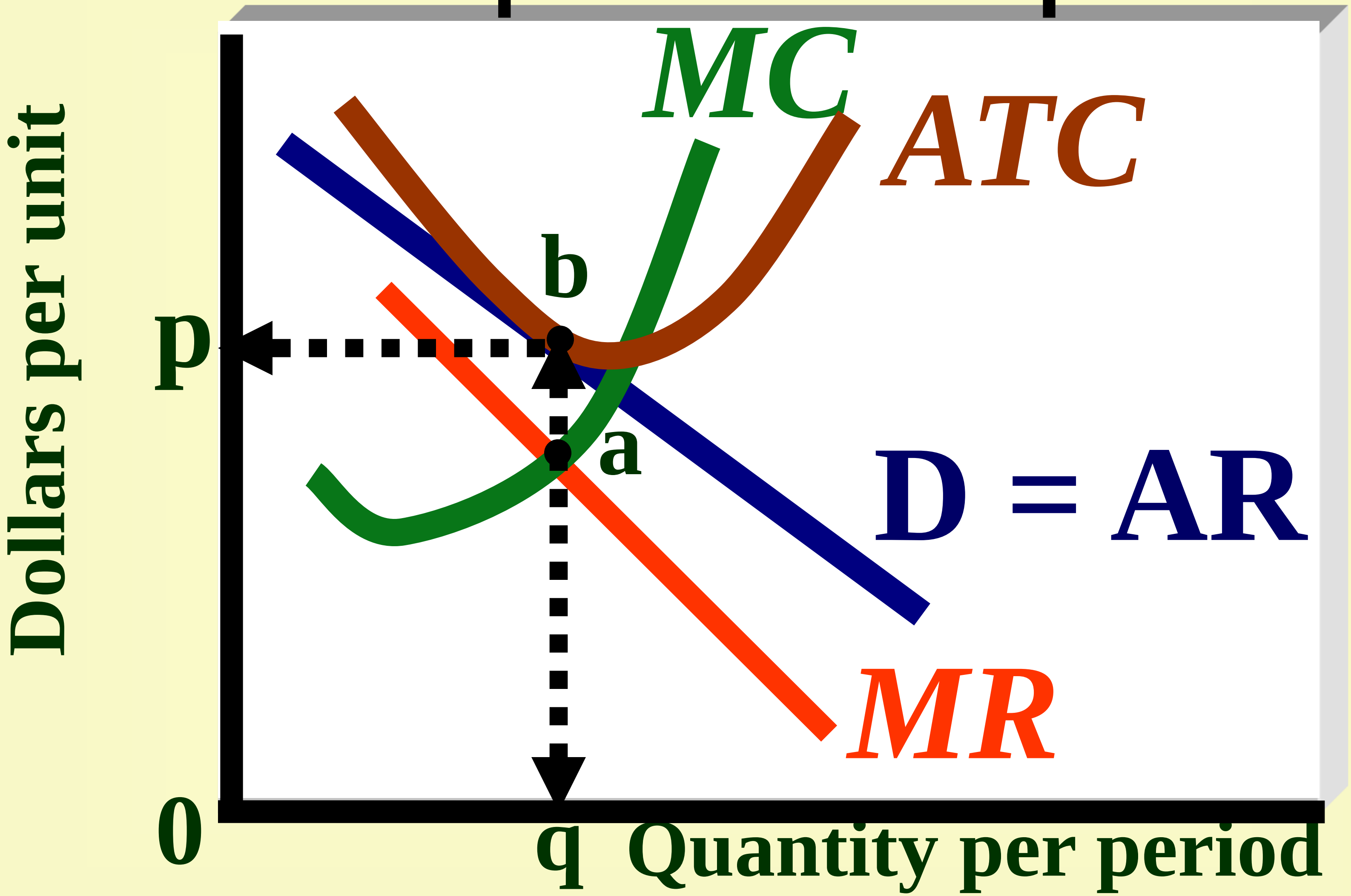


Exhibit 2

How does monopolistic competition compare with perfect competition?

They both make a normal profit over the long-run

Perfect Competition

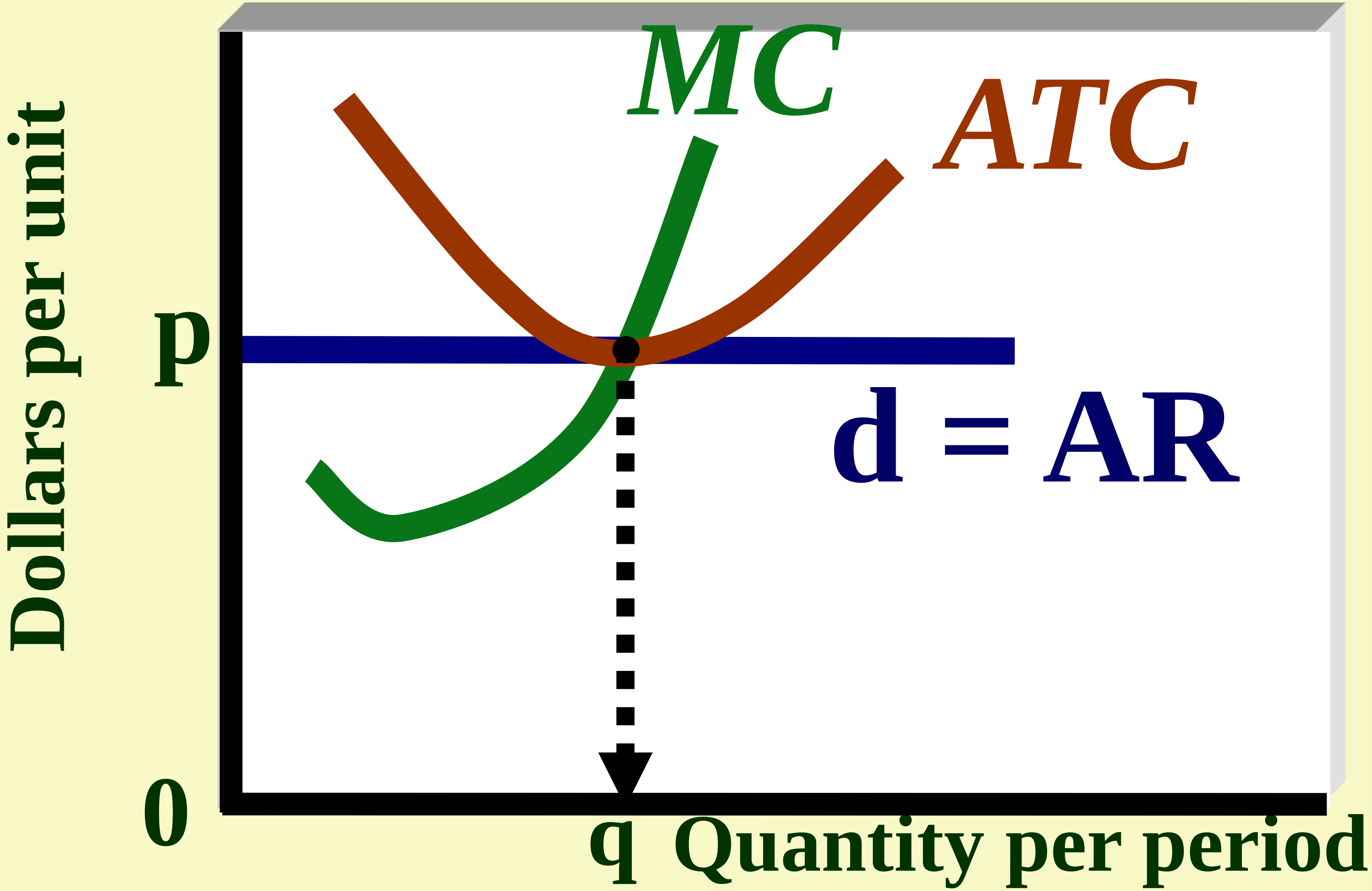


Exhibit 3 (a)

Long Run Equilibrium in Monopolistic Competition

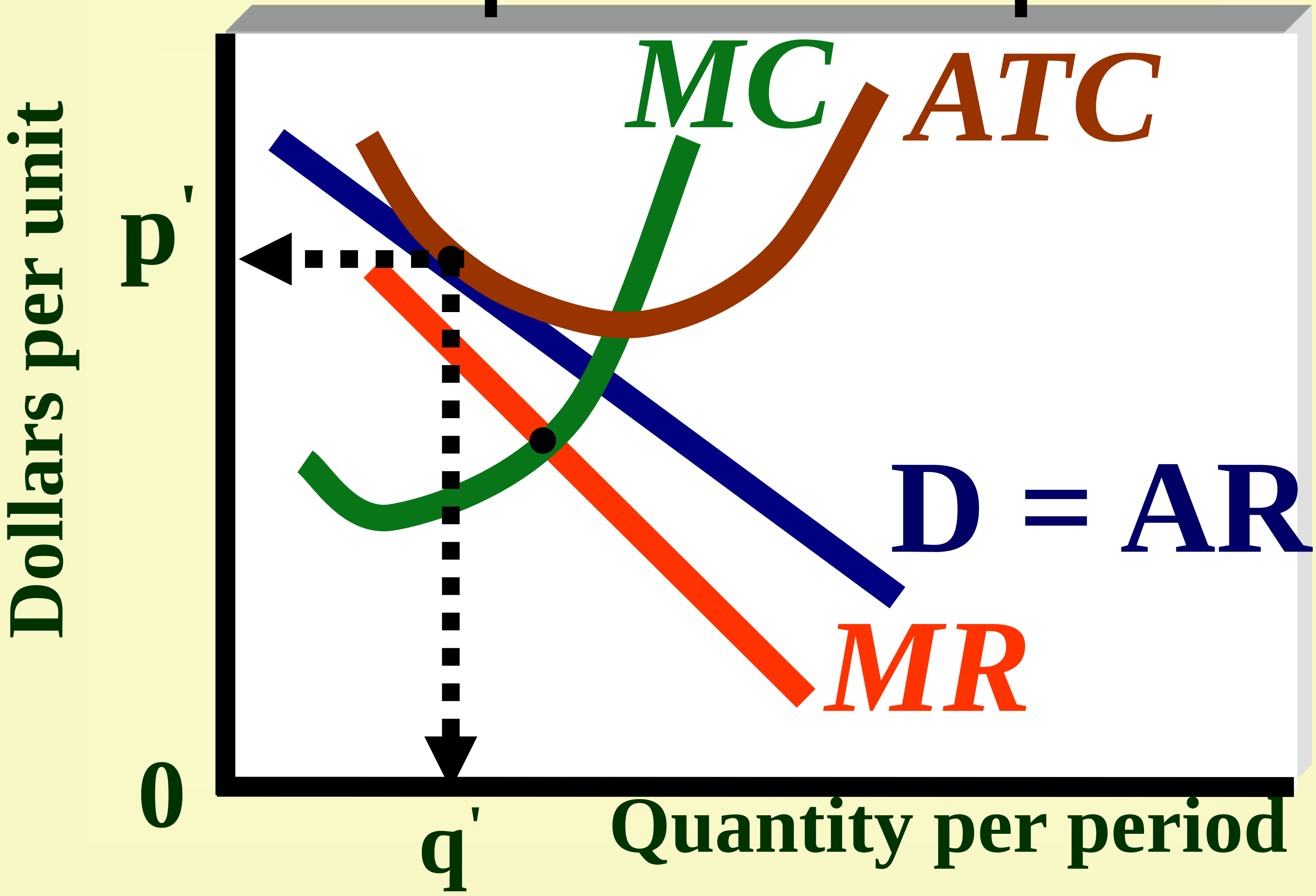


Exhibit 2 (b)

What is an oligopoly?

A market structure characterized by a small number of firms whose behavior is interdependent

What are examples of oligopoly?

- Automobiles
- Steel
- Soup
- Cereals

What is a possible explanation for the formation of oligopolies?

Barriers to entry, such as economies of scale or a high cost of entry

Economies of Scale as Barriers to Entry

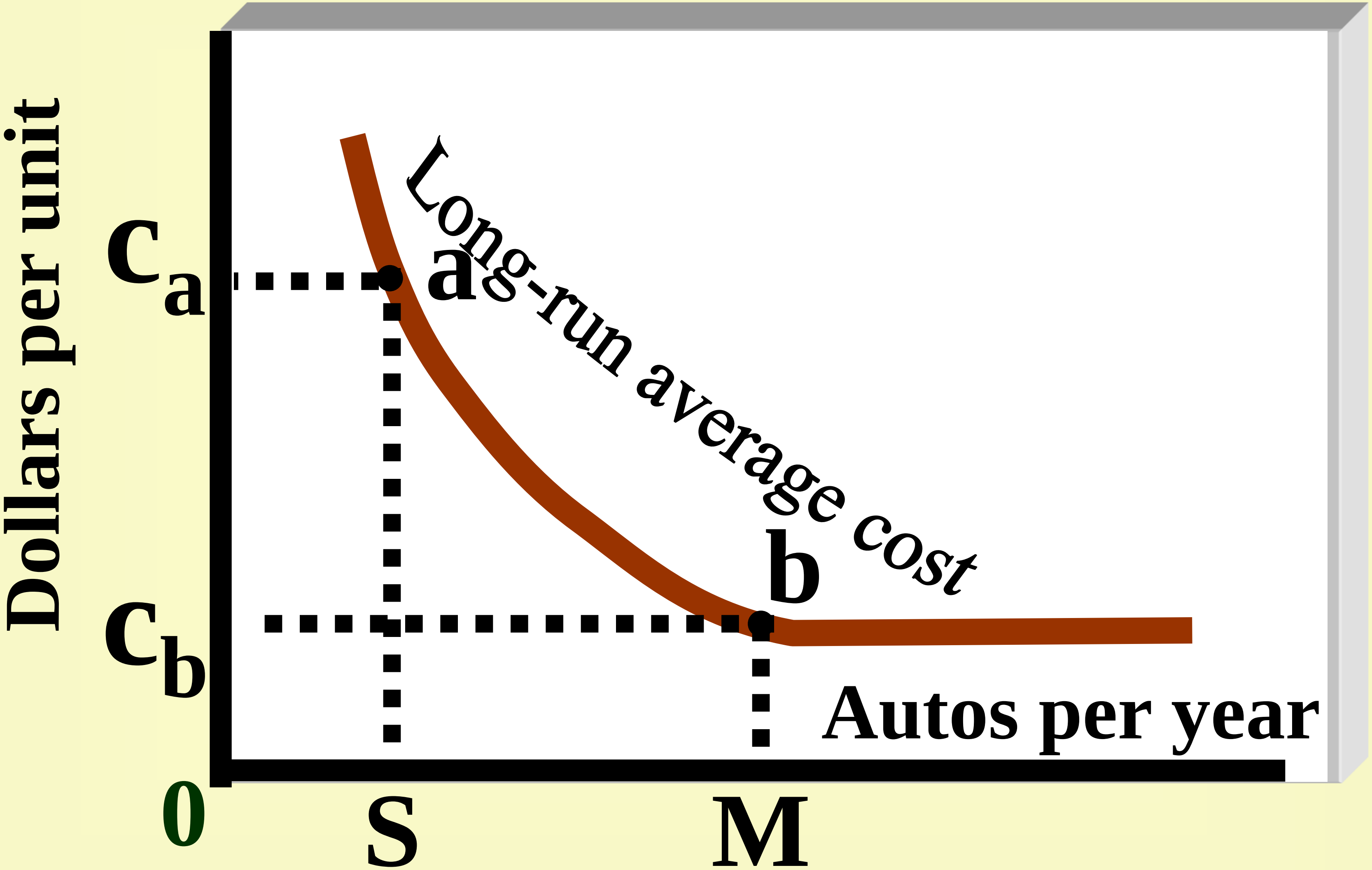


Exhibit 4

What is a collusion?

An agreement among firms to divide the market or to fix the market price to maximize economic profit

What is explicit collusion?

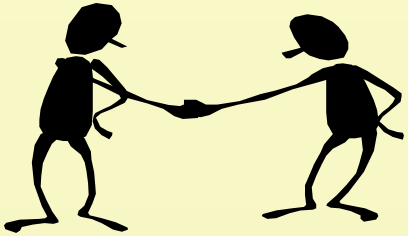
Cooperation involving direct communication between competing firms about setting prices

What is implicit collusion?

Cooperation involving indirect communication between competing firms about setting prices

What is a *cartel*?

A group of firms that agree to coordinate their production and pricing decisions, thereby behaving as a monopolist



What are two examples of cartels?

- Organization of Petroleum Exporting Countries (OPEC)
- International Electrical Association (IEA)

Cartel Model Where Firms Act as a Monopolist

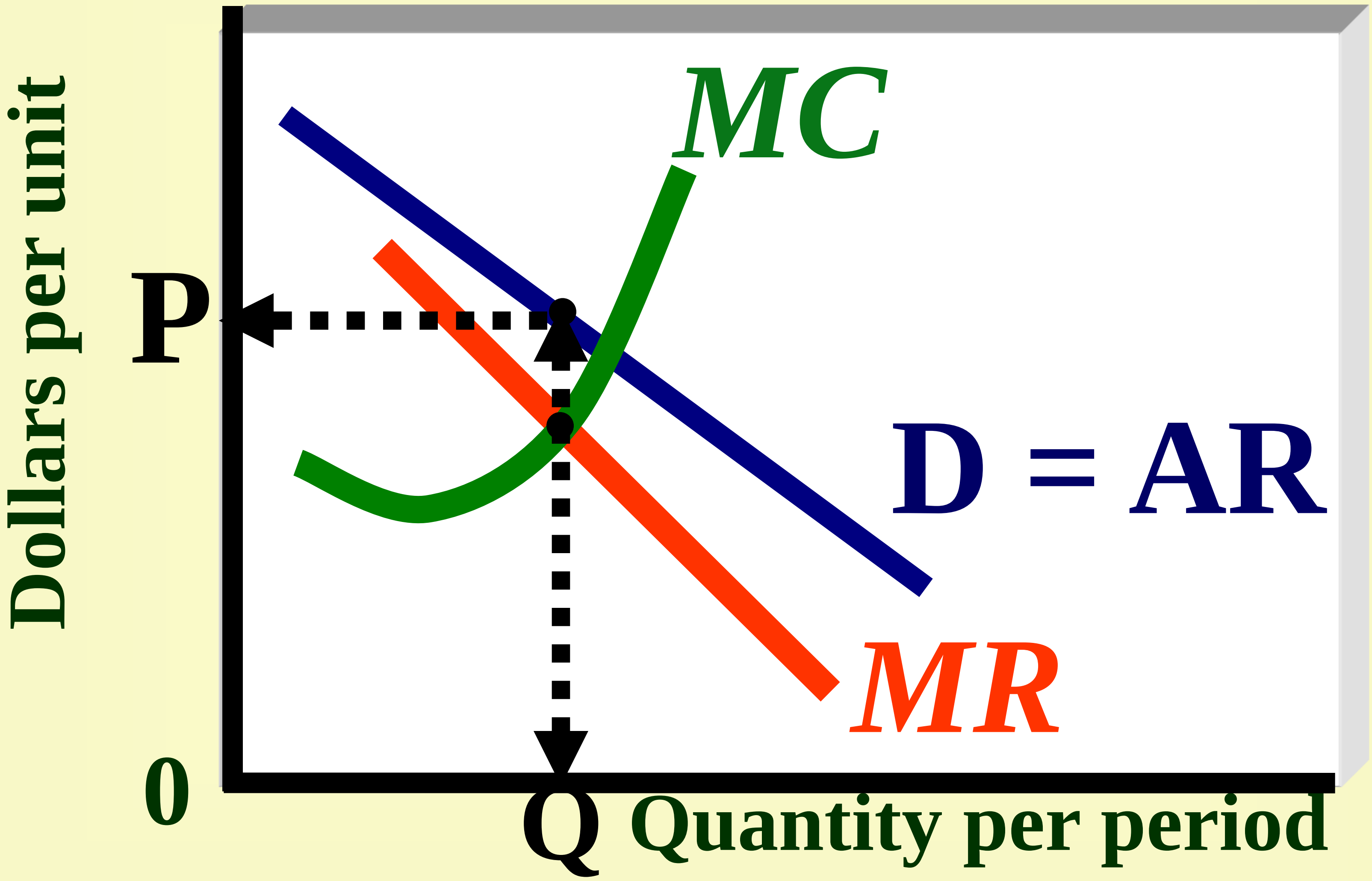


Exhibit 5

What are the problems of stability?

- Differences in costs
- Number of firms
- New entry
- Cheating

What distinguishes oligopoly?

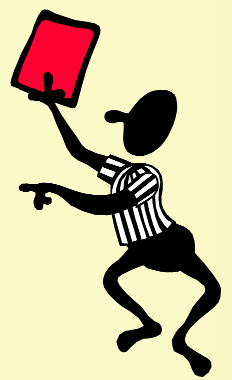
Interdependence - No firm will not take an action unless it considers the reaction from the other firms

Imagine 3 identical firms in an industry – A, B, C. What happens if A raises price?

B and C will not raise their price

Imagine 3 identical firms in an industry – A, B, C. What happens if A lowers price?

B and C will lower their price



What is a price leader?

A firm whose price is adopted by the rest of the industry

Who is the price leader?

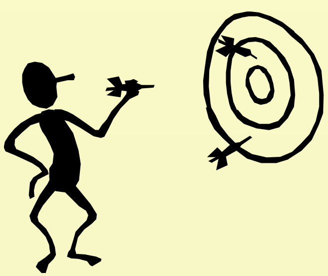
- barometric-firm
- dominant firm
- most innovative

What is cost-plus pricing?

A method of determining the price of a good by adding a percentage markup to average variable cost

What is game theory?

A model that analyzes oligopolistic behavior as a series of strategic moves and countermoves by rival firms

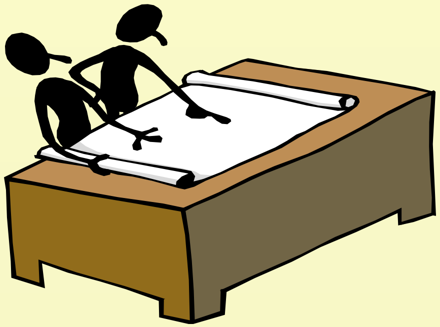


What is a duopoly?

A market with only two producers, who compete with each other; a type of oligopoly market structure

What is strategy?

In game theory, the operational plan pursued by a player



What is a payoff matrix?

In game theory, a table listing the payoffs that each player can expect based on the strategy that each player pursues

What is a kinked demand curve?

A demand curve that illustrates price stickiness; if one firm cuts prices, others will cut theirs, but if the firm raises prices, others will not change theirs

The Kinked Demand Model of Oligopoly

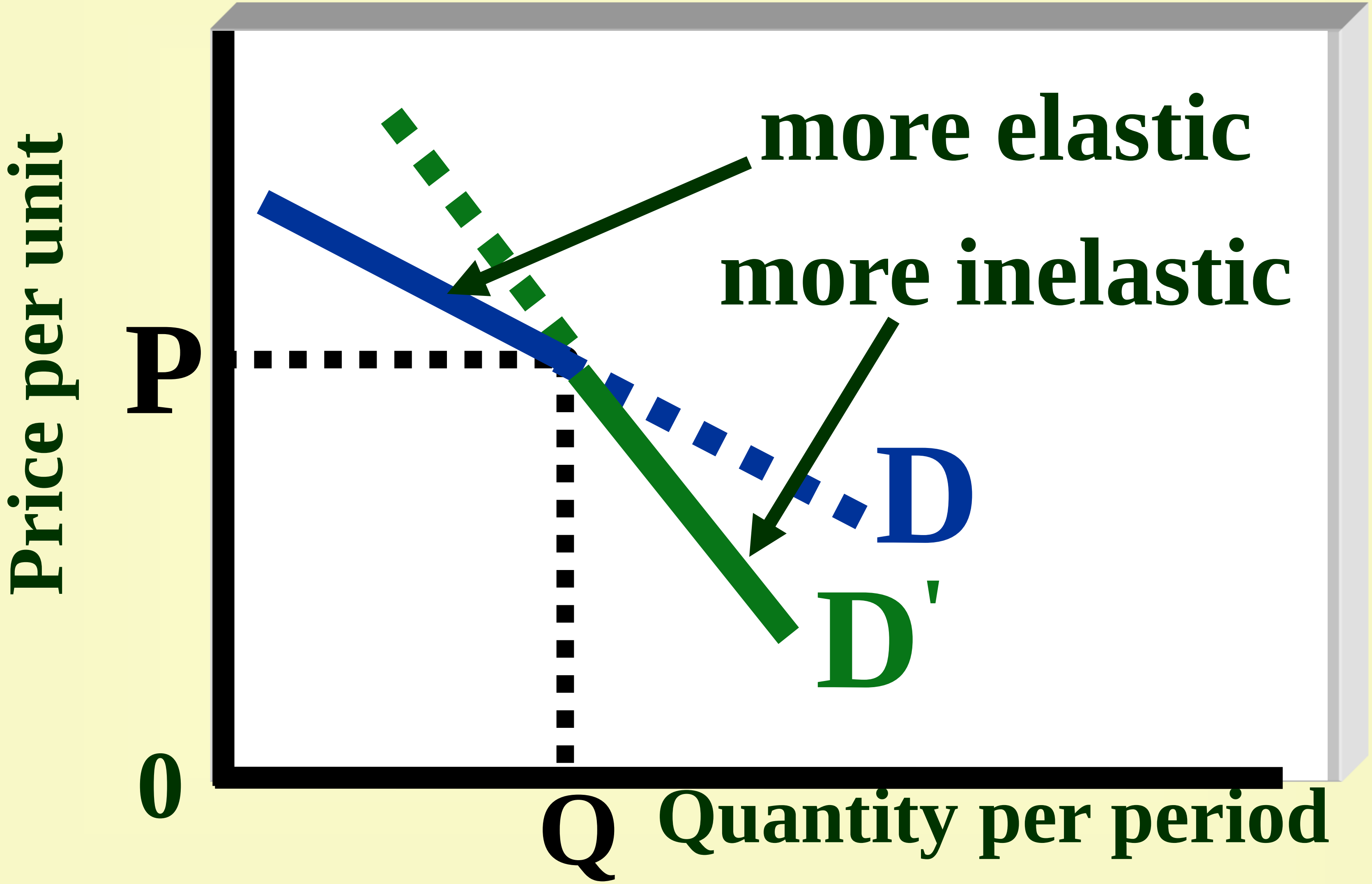


Exhibit 7

D and MR Curves for the Kinked Demand Model

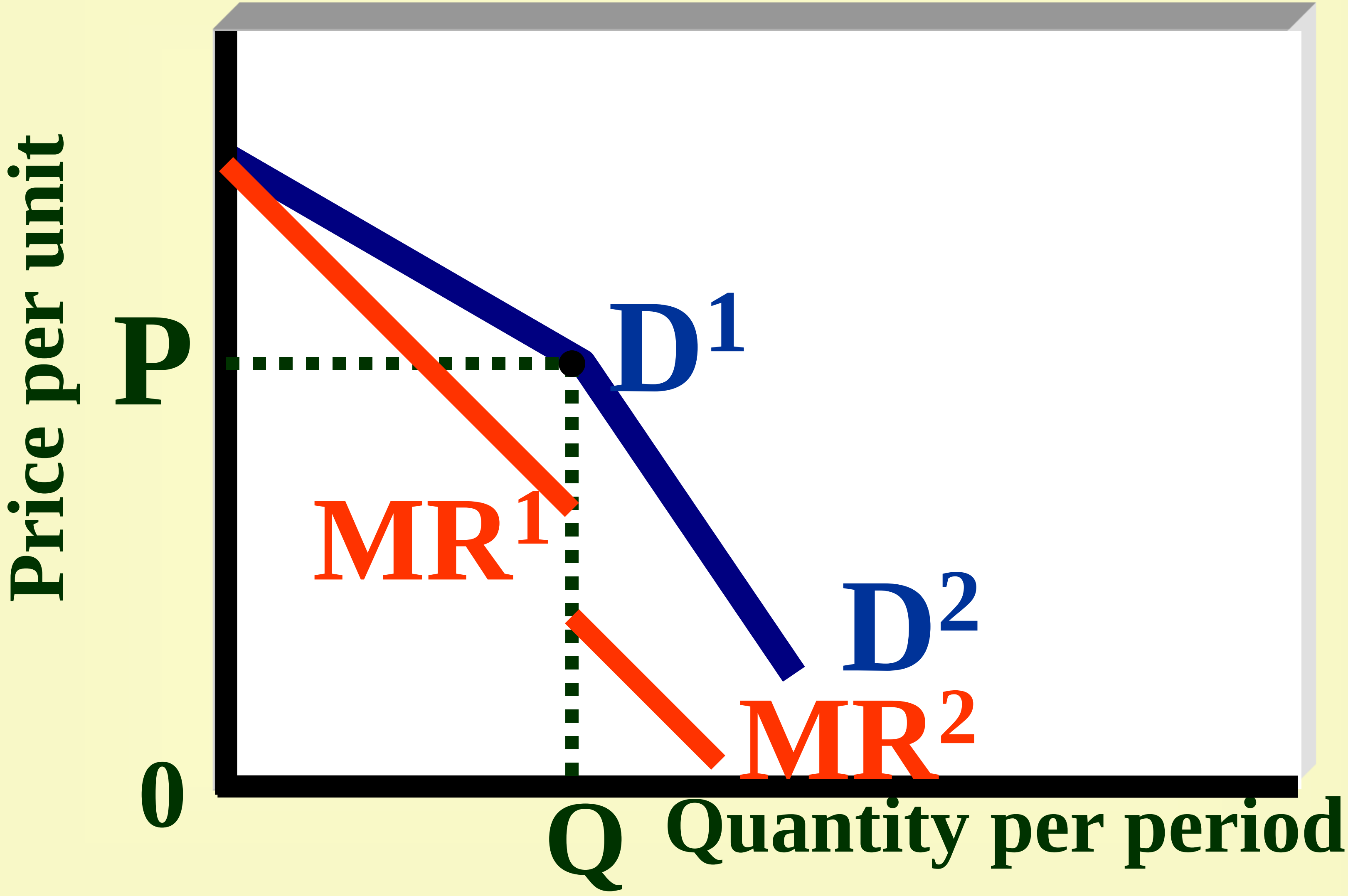


Exhibit 8

How does price under an oligopoly compare to price under perfect competition?

Price is usually higher under an oligopoly

How do profits under an oligopoly compare to profits under perfect competition?

Profits are higher under an oligopoly

What is a horizontal merger?

A merger in which one firm combines with another firm that produces the same product

What is a vertical merger?

A merger in which one firm combines with another from which it purchases inputs or to which it sells output

What is a conglomerate merger?

A merger involving the combination of firms producing in different industries

END